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MONETARY POLICY, INTEREST RATES, MONEY AND CREDIT

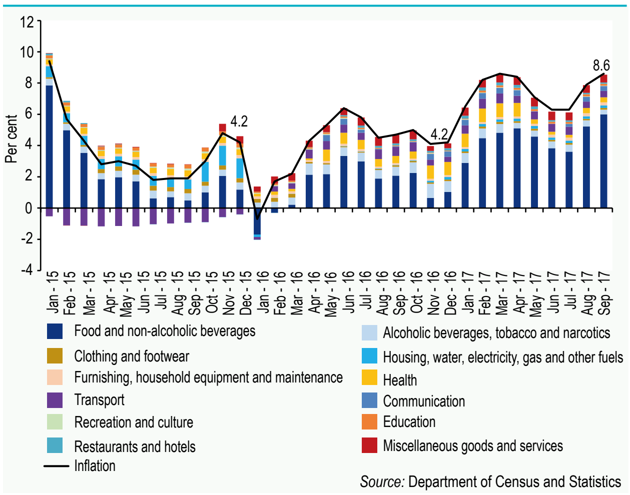
The Central Bank maintained a tight monetary policy stance during the first nine months of 2017 to preempt the buildup of excessive demand pressures and adverse inflation expectations in the economy. The policy interest rates of the Central Bank were increased by 25 basis points (bps) in March 2017, in addition to the 100 bps increase in policy interest rates and the 1.50 percentage point increase in the Statutory Reserve Ratio (SRR) in 2016. The year-on-year headline inflation, measured using the Colombo Consumer Price Index (CCPI) and the National Consumer Price Index (NCPI), remained in single digits, but above the desired levels during most months, mainly reflecting the impact of tax adjustments made in 2016 as well as high food inflation driven by adverse weather conditions. Meanwhile, broad money supply continued to expand at an elevated pace, caused by the gradual buildup of net foreign assets of the banking system as well as the continued, but slower, expansion in domestic credit disbursed by the banking system to both the private and public sectors. Credit obtained by the government from the Central Bank declined, although net credit to the government from commercial banks remained high. Credit extended to public corporations by the banking system expanded in 2017, although some moderation has been observed since June 2017. Credit extended to the private sector by commercial banks decelerated gradually during the year responding to tighter monetary conditions in the economy as reflected by high nominal and real interest rates. The monetary policy stance, along with the decline in market liquidity conditions, caused further upward adjustments in market interest rates, during the first half of the year. However, surplus rupee liquidity, which was observed in the market since July 2017, resulted in a moderation of interest rates in the interbank call money market and prompted other bank interest rates to stabilise at high levels. Increased foreign financial inflows to the government, improved revenue collection, and improvements to the auction system for government securities, caused a notable reduction in the yields of government securities since April 2017. Going forward, monetary expansion is expected to decelerate with the gradual moderation of the growth of private sector credit and envisaged fiscal consolidation. Although inflation is expected to remain elevated in the near term due to food price volatility, inflation outlook remains favourable in the medium term.

Monetary Policy Stance of the Central Bank

- **The Central Bank of Sri Lanka conducted its monetary policy within an enhanced monetary policy framework with the intention of transiting to Flexible Inflation Targeting (FIT) in the medium term to stabilise inflation in mid-single digits of 4 - 6 per cent, thereby facilitating a sustainable growth trajectory**. Under the current enhanced monetary policy framework, the conduct of monetary policy is grounded on market based monetary policy instruments, particularly policy interest rates and open market operations, to guide the average weighted call money rate (AWCMR), which is the operating target of the framework. Broad money (M_{2b}) remains a key indicative intermediate variable of this framework to guide the conduct of monetary policy. To facilitate the transition towards FIT, the monetary policy formulation process is being enriched with more forward looking monetary policy analysis complemented by several institutional changes within the Central Bank. Further, the Central Bank adopted a more flexible exchange rate policy during the first nine months of 2017, as announced, to complement the current monetary policy measures and support the transition to FIT. At the same time, as the successful implementation of FIT hinges on reliable medium term forecasts of key macroeconomic variables and macroeconomic simulation and policy analysis, a Forecasting and Policy Analysis System (FPAS) has been developed by the Central Bank with the assistance of the International Monetary Fund (IMF), which is currently being integrated into the monetary policy formulation process of the Central Bank. Further, as announced in the "Road Map: Monetary and Financial Sector Policies for 2017 and beyond" (Road Map 2017), the number of Monetary Policy Committee (MPC) meetings was reduced to eight meetings per year in order to provide staff sufficient time for deeper macroeconomic analysis and forecasting. Moreover, the Monetary Policy Consultative Committee (MPCC) comprising academics, professionals and private sector representatives was re-established in 2017, enabling the Central Bank to obtain views of the private sector to be used in the monetary policy formulation process.

- **Consumer price inflation remained at higher than desired levels thus far in 2017 due to the combined effect of tax revisions, domestic weather related disturbances and rising commodity prices in the global market**. Headline inflation, as measured by the year-on-year change in the National Consumer Price Index (NCPI, 2013=100), remained high during the first quarter of 2017, mainly reflecting the impact of supply side disruptions on account of adverse weather conditions as well as the impact of tax revisions. However, improvements in supply conditions with the dissipation of weather related disturbances and the government's initiatives to facilitate imports of essential food items eased price pressures in the domestic market, helping inflation to gradually moderate during the second quarter of the year. However, NCPI based headline inflation increased again and reached 8.6 per cent in September 2017, mainly reflecting high food inflation. On an annual average basis, NCPI based headline inflation was 6.8 per cent in September 2017, compared to 4.0 per cent recorded at end 2016. Meanwhile, Colombo Consumer Price Index (CCPI 2013=100) based headline inflation also recorded a similar movement and peaked at 7.3 per cent, year-on-year, in March 2017 before gradually declining to 4.8 per cent in July 2017 due to the decline in food inflation with the moderation of the impact of supply disruptions. Thereafter, CCPI based headline inflation increased again to 7.1 per cent in September 2017, mainly due to the sharp increase in food inflation. On an annual average basis, CCPI based headline inflation stood at 5.8 per cent in September 2017 compared to 4.0 per cent at end 2016.

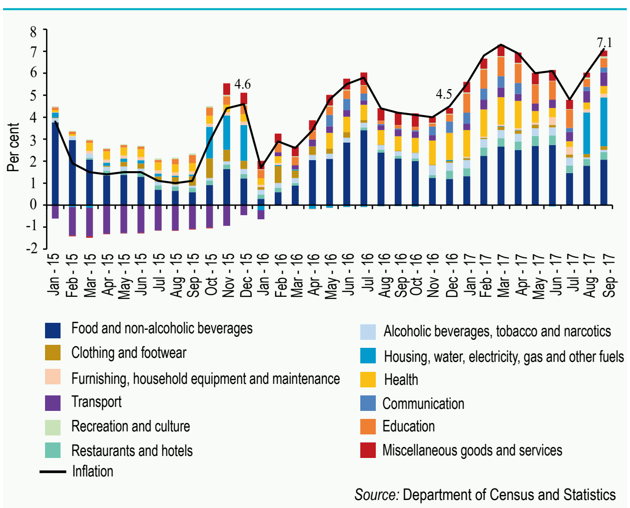
Chart 7.1
Contribution to Year-on-Year Headline Inflation (NCPI)



Source: Department of Census and Statistics

- **Core inflation, which is generally considered as the demand driven component of inflation, indicated an upward trend during the first quarter of 2017 before moderating thereafter**. The increase in core inflation during the first quarter of 2017 was largely driven by the prices of the non-food category, and the effect of tax revisions was also observed in the movement of core inflation. Partly reflecting the response to demand management policies of the Central Bank, core inflation remained below headline inflation during most months. Accordingly, NCPI based core inflation declined to 4.6 per cent, year-on-year, in September 2017, compared to 6.7 per cent recorded at end 2016. On an annual average basis, NCPI based core inflation was 5.7 per cent in September 2017 in comparison to 5.9 per cent at end 2016. CCPI based core inflation was recorded at 6.0 per cent, year-on-year, in September 2017 in comparison to 5.8 per cent at end 2016, while on an annual average basis, it was at 5.8 per cent in September 2017, in comparison to 4.4 per cent at end 2016.

Chart 7.2
Contribution to Year-on-Year Headline Inflation (CCPI)



Source: Department of Census and Statistics

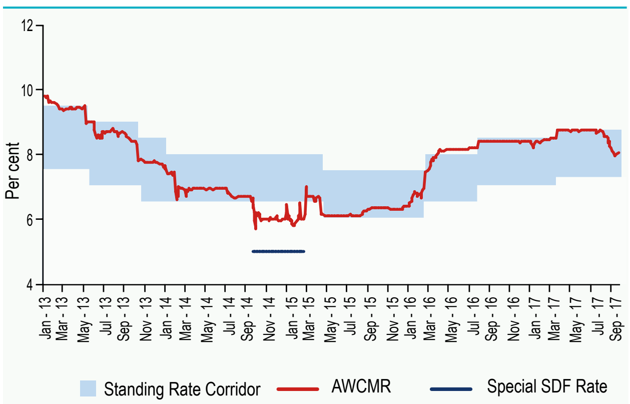
- **Thus far in 2017, inflation expectations of economic agents remained broadly contained in view of the forward looking monetary policy conduct of the Central Bank**. Inflation expectations of the corporate sector as per the Inflation Expectations Survey of the Central Bank showed an upward movement during the early part of 2017, but improved thereafter indicating the views of the corporate sector on the possible easing of price pressures. Nevertheless, inflation expectations of the household sector indicated an upward bias till June 2017 before moderating thereafter. Domestic supply side disruptions due to unfavourable weather conditions and the impact of tax revisions were the main contributory factors for the upward movement in inflation expectations. In addition, the increase in prices in the domestic and international markets was also highlighted by respondents as a factor affecting their sentiments on future inflation.

- **In view of the developments mainly on the inflation front and monetary aggregates, the Central Bank pursued a tight monetary stance thus far in 2017**. In January 2016, the Central Bank commenced monetary tightening by raising the Statutory Reserve Ratio (SRR) applicable on all rupee deposit liabilities of licensed commercial banks by 1.50 percentage points to 7.50 per cent. The Central Bank also raised policy interest rates by a total of 100 basis points in two steps during 2016 to preempt the buildup of demand driven inflationary pressures and excessive monetary and credit expansion. Meanwhile, monetary tightening measures coupled with declining levels of market liquidity caused an upward adjustment in market interest rates. However, amidst upward adjustment in lending rates, credit disbursements to the private sector by commercial banks continued to expand beyond the desired levels. Driven by the excessive domestic credit flows to the private sector as well as to the public sector, monetary expansion continued to be high during the latter part of 2016 and early 2017. Considering these developments, and to contain second round effects of price increases, which were driven by supply side factors and tax adjustments, the Central Bank further tightened the monetary policy stance by raising its policy interest rates by 25 basis points in March 2017. The Standing Deposit Facility Rate (SDFR) and the Standing Lending Facility Rate (SLFR) of the Central Bank remained at 7.25 per cent and 8.75 per cent, respectively, thereafter. Reflecting the transmission of the tight monetary policy stance of the Central Bank, market interest rates increased, and a gradual deceleration in the growth of credit to the private sector was observed thus far in 2017.

- **In order to steer overnight interest rates consistent with monetary policy objectives, the Central Bank conducted open market operations (OMO) effectively**. Rupee liquidity in the domestic money market showed a mixed movement in view of the domestic and foreign currency operations of the Central Bank and the government treasury operations, but remained mostly negative during the first seven months of 2017. At the beginning of the year, the Central Bank conducted repurchase auctions and outright sales of Treasury bills to absorb the excess liquidity that prevailed in the market. As market liquidity remained mostly at deficit levels during February to mid July 2017, the Central Bank injected liquidity into the market through reverse repurchase auctions and standing facilities. The deficit liquidity levels prompted the AWCMR to remain around the upper bound of the policy rate corridor. As a result of tight monetary policy measures amidst deficit liquidity conditions, deposit and lending rates of commercial banks also increased gradually. However, in line with the improvements in market liquidity conditions from mid July 2017, short term interest rates, particularly AWCMR and Sri Lanka Inter Bank Offered Rates (SLIBOR) indicated a moderation.

Chart 7.3

Standing Rate Corridor and Average Weighted Call Money Rate (AWCMR)



Source: Central Bank of Sri Lanka

- **The communication strategy of the Central Bank continued to aim at enhancing the transparency of communicating monetary policy decisions to the general public, while guiding expectations of economic agents appropriately**. Through its Road Map, the Central Bank published an advance release calendar for monetary policy announcements at the beginning of the year. Moreover, the press release on the review of the monetary policy stance, which explained the rationale for the monetary policy decision, continued to be the key mode of announcing monetary policy decisions to the market. In addition, each monetary policy review announcement was followed by a media conference chaired by the Governor and attended by senior officials of the Central Bank. This move is critical in helping to build and maintain policy credibility of the Central Bank, which is crucial to ensure the effectiveness of monetary policy. At the same time, issuing regular and occasional communiqués, conducting of seminars and lectures as well as delivering speeches by the

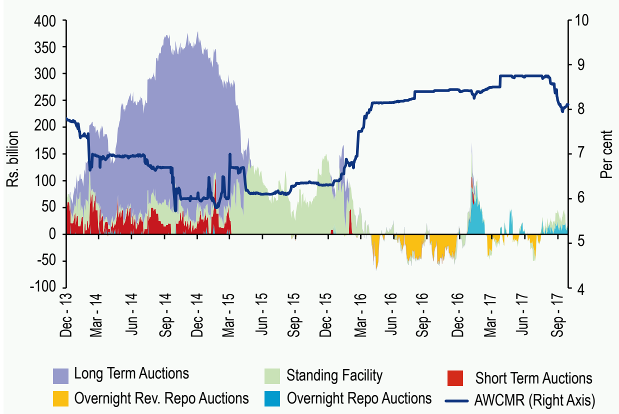
Governor and the senior officials of the Central Bank enabled managing inflation expectations of the public. Meanwhile, the Central Bank continued to release its regular publications and useful economic information on a daily, weekly, monthly, quarterly and annual basis in all three languages, through online and print media.

Movements in Interest Rates

Market Liquidity, Market Operations and Short Term Interest Rates

- **Rupee liquidity in the domestic money market remained mostly tight until mid July 2017 and turned to positive levels thereafter**. The money market, which operated with deficit liquidity conditions mostly in the latter part of 2016, recorded surplus overnight liquidity for a short period during December 2016-January 2017 mainly due to the return of currency to the banking system after the festive season, the release of provisional advances to the government as well as the maturing term repurchase agreements with the Central Bank. Since the early part of February 2017, however, excess liquidity declined significantly and remained in the negative territory as a result of the maturing of Treasury bill holdings of the Central Bank as well as the net foreign exchange sales by the Central Bank in the first quarter of 2017 in view of capital outflows. Even though liquidity turned to surplus levels occasionally due to the returning of currency into the banking system after the New Year season, foreign exchange purchases by the Central Bank on a net basis and conversion of a part of the International Sovereign Bond (ISB) proceeds, liquidity remained mostly in deficit levels averaged around Rs. 7.9 billion during the early February to mid July 2017 period due to the substantial retirements of Treasury bill holdings of the Central Bank. Continued foreign exchange purchases by the Central Bank and further conversions of ISB proceeds and foreign loans received by the government led to a turnaround in domestic money market liquidity into a surplus level since mid July 2017. Accordingly, the liquidity surplus in the domestic money market during mid July to September 2017 averaged around Rs. 25.0 billion. In line with these developments, the Central Bank engaged in conducting OMO through auctions and providing standing facilities as required, to ensure the stability in overnight interest rates.

Chart 7.4
Rupee Liquidity in the Domestic Money Market and Liquidity Management



Source: Central Bank of Sri Lanka

- **Overnight money market rates hovered around the upper bound of the policy rate corridor during the first seven months of 2017 reflecting tight monetary conditions, and a downward movement towards the middle of the policy rate corridor was observed since mid July 2017 in response to improved liquidity conditions**. AWCMR, which adjusted downwards in January 2017 with the transitory improvements in market liquidity levels, moved upwards and remained around the upper bound of the policy rate corridor thereafter, as market liquidity levels declined and policy interest rates were increased in March 2017. Nevertheless, with the improvements in money market liquidity levels, AWCMR, which was at 8.75 per cent, started adjusting downwards since mid July 2017 and reached 8.11 per cent by end September 2017. Following a similar trend, weighted average

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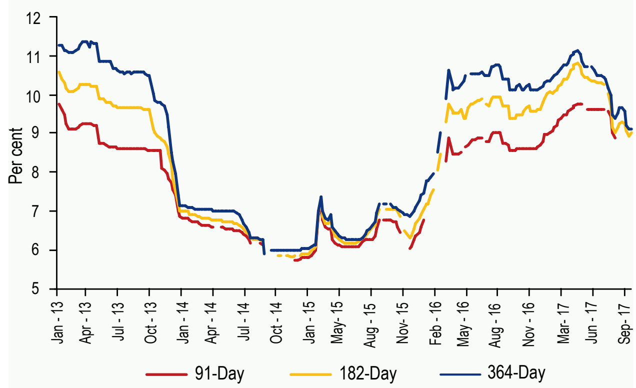
yields at the daily OMO auctions adjusted upwards gradually until mid July 2017 responding to the movements in policy interest rates and liquidity shortage, before moving downwards since mid July 2017 with improved liquidity conditions in the money market. Meanwhile, the SLIBOR adjusted in line with the movements in the AWCMR and liquidity conditions, and overnight and 12-months SLIBOR were at 8.11 per cent and 11.99 per cent, respectively, by end September 2017, compared to 8.44 per cent and 12.00 per cent recorded at end 2016.

Yields on Government Securities

- **Although an increase was observed during the first four months of 2017, yields on government securities declined considerably thereafter, in response to favourable market sentiments arising from improved fiscal performance, availability of foreign financing and the improvements made to the auction system**. Yields on Treasury bills in the primary market showed an upward movement during the first four months of 2017, reflecting the impact of increased demand for funds by the government within a purely auction based system for issuing government securities as well as the transmission of tight monetary conditions. Accordingly, by end April 2017, yields on 91- day, 182-day and 364-day Treasury bills increased by 101 basis points, 107 basis points and 85 basis points, respectively, compared to the yields that prevailed at end 2016. However, due to increased foreign inflows to the government securities market since March 2017 as well as the receipt of the proceeds of the ISB amounting to US dollars 1.5 billion and the syndicate loan proceeds totaling US dollars 1.0 billion, the pressure in the government securities market reduced substantially. Further, increased government revenue collection and the receipt of the third tranche of the IMF-EFF Programme also helped enhance market expectations. In response to these developments, yields of 91-day, 182-day and 364-day Treasury bills decreased by 102, 169 and 192 basis points to 8.71 per cent, 9.01 per cent, and 9.10 per cent, respectively, by end September 2017 compared to the yields recorded at end April 2017.

Chart 7.5
Primary Market Treasury Bill Yields (a)



Source: Central Bank of Sri Lanka

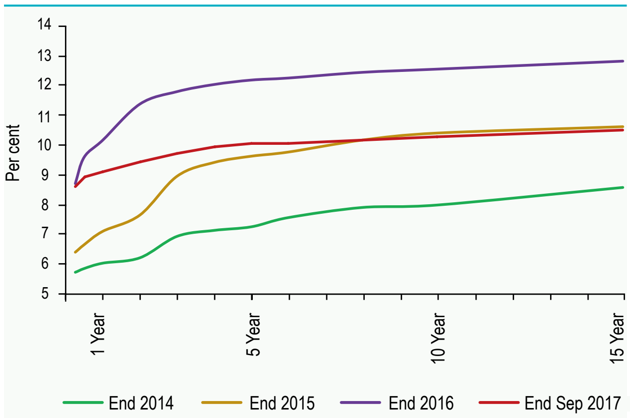
(a) Yield rates for some weeks are not available.

- **Following short term yields, rates on Treasury bonds in the primary market also declined since April 2017**. In view of the high borrowing requirements of the government, yields on Treasury bonds displayed an increasing trend during the first quarter of 2017, before declining thereafter. Considering the high interest rates, the government relied more on short and medium term Treasury bonds during the first nine months of 2017. Yields on 5-year Treasury bonds, which increased from 12.16 per cent in early January 2017 to 12.60 per cent by early April 2017, moderated to 10.09 per cent by end September 2017. Yields on 10-year Treasury bonds also declined from 12.11 per cent by end 2016 to 10.31 per cent by end September 2017. Similar movements were observed in the yields pertaining to Treasury bonds of other maturities as well. Meanwhile, the government issued short and medium term US dollar denominated Sri Lanka Development Bonds (SLDBs) at various fixed and floating rates. Further, a 10-year ISB was issued in May 2017 at a relatively low rate of 6.20 per cent. The issuance of these foreign currency denominated debt securities helped to ease the pressure on yields of domestic debt instruments to a great extent. Meanwhile, in order to enhance the efficiency and transparency of domestic borrowings of the government, the Central Bank introduced a new primary issuance system for Treasury bonds in July 2017.

- **The secondary market yields that increased during the first four months of 2017, declined thereafter, leading to a sharp downward shift in the yield curve for government securities, particularly from the long end**. The yields on short term maturities declined marginally, while the long term yields declined substantially. Accordingly, the yields on 91-day, 182-day and 364-day Treasury bills declined by 8 basis points, 68 basis points and 106 basis points, respectively, by end September 2017, in comparison to the yields observed at end 2016. Secondary market yields on Treasury bonds declined within a range of 196 to 242 basis points by end September 2017, in comparison to the yields observed at end 2016. This downward shift in the yield curve could be attributed to favourable market expectations in view of continued fiscal consolidation and improved debt management strategies as well as favourable inflation expectations over the medium term, as a result of forward looking monetary policy decisions.

Chart 7.6

Secondary Market Yield Curve for Government Securities



Source: Central Bank of Sri Lanka

Table 7.1

Movements in Interest Rates

Per cent per annum

Interest Rate	End 2016	End September 2017
Policy Interest Rates		
Standing Deposit Facility Rate	7.00	7.25
Standing Lending Facility Rate	8.50	8.75
Average Weighted Call Money Rate (AWCMR)	8.42	8.11
Yield Rates on Government Securities		
Primary Market (a)		
Treasury bills		
91-day	8.72	8.71
182-day	9.63	9.01
364-day	10.17	9.10
Treasury bonds		
2-year	11.04	9.83
3-year	11.62	-
4-year	11.94	11.14
5-year	11.76	10.09
10-year	12.11	10.31
Secondary Market		
Treasury bills		
91-day	8.69	8.61
182-day	9.60	8.92
364-day	10.17	9.11
Treasury bonds		
2-year	11.38	9.42
3-year	11.80	9.71
4-year	12.04	9.94
5-year	12.18	10.04
10-year	12.55	10.28
Licensed Commercial Banks (b)		
Interest Rates on Deposits		
Savings Deposits	0.50-9.00	0.50-9.50
1 Year Fixed Deposits (c)	4.50-15.00	4.89-15.00
Average Weighted Deposit Rate (AWDR)	8.17	9.25
Average Weighted Fixed Deposit Rate (AWFDR)	10.46	11.81
Average Weighted New Deposit Rate (AWNDR)	11.17	11.04 (d)
Interest Rates on Lending		
Average Weighted Prime Lending Rate (AWPR)	11.73	11.42
Average Weighted Lending Rate (AWLR)	13.20	13.90 (d)
Average Weighted New Lending Rate (AWNLR)	14.37	15.12 (d)
Other Financial Institutions (e)		
Interest Rates on Deposits		
National Savings Bank		
Savings Deposits	4.25	4.00
1 - year Fixed Deposits	11.00	11.00
Licensed Finance Companies (f)		
Savings Deposits	5.38-7.74	5.44-7.84 (d)
1 - year Fixed Deposits	12.13-14.06	12.53-14.08 (d)
Interest Rates on Lending		
National Savings Bank	9.75-15.00	13.00-16.00
State Mortgage and Investment Bank (g)	10.50-20.00	10.50-20.00
Licensed Finance Companies (f)		
Finance Leasing	17.48-25.97	17.52-29.29 (d)
Hire Purchase	17.51-22.65	16.83-20.77 (d)
Loans against Real Estate	19.12-20.80	18.03-20.23 (d)
Corporate Debt Market		
Debentures	9.60-13.75	12.75-15.00 (d)
Commercial Paper	8.70-14.80	14.25-16.50 (d)

Sources: Colombo Stock Exchange
Respective financial institutions
Central Bank of Sri Lanka

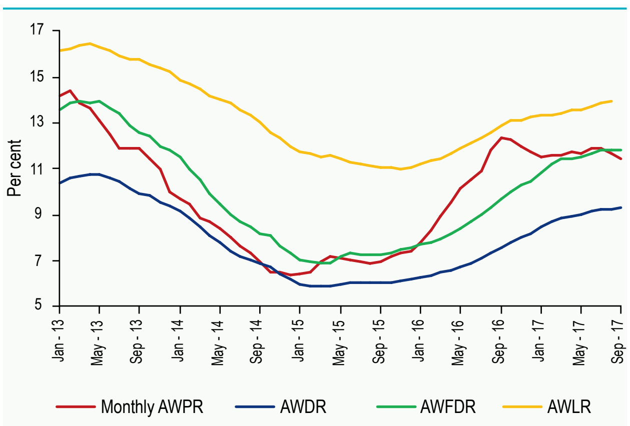
(a) Weighted average yield rates at the latest available auction.
(b) Based on the rates quoted by commercial banks.
(c) Maximum rate is a special rate offered by certain Commercial banks.
(d) As at end August 2017.
(e) Based on the rates quoted by other selected Financial Institutions.
(f) Interest rate ranges are based on the average maximum and average minimum rates quoted by LFCs. Data for 2017 are provisional.
(g) Lending for housing purposes only.

Deposit and Lending Interest Rates

- **Deposit interest rates of commercial banks continued to increase particularly during the first seven months of 2017**. Reflecting the increased competition among banks to mobilise deposits from the general public amidst tight monetary conditions in the market, deposit interest rates increased during the period under review. Accordingly, the average weighted deposit rate (AWDR), which reflects the movements in interest rates pertaining to all outstanding interest bearing deposits held with commercial banks, increased by 108 basis points to 9.25 per cent by end September 2017 from 8.17 per cent at end 2016. Meanwhile, the average weighted fixed deposit rate (AWFDR), which is based on interest rates pertaining to all outstanding time deposits held with commercial banks, also increased by 135 basis points to 11.81 per cent by end September 2017 from 10.46 per cent at end 2016. Moreover, the average weighted new deposit rate (AWNDR), which captures the interest rates pertaining to all new interest bearing deposits, increased by 55 basis points to 11.72 per cent by end July 2017 from 11.17 per cent at end December 2016. However, following the declining trend in other short term interest rates, AWNDR declined to 11.04 per cent by end August 2017.

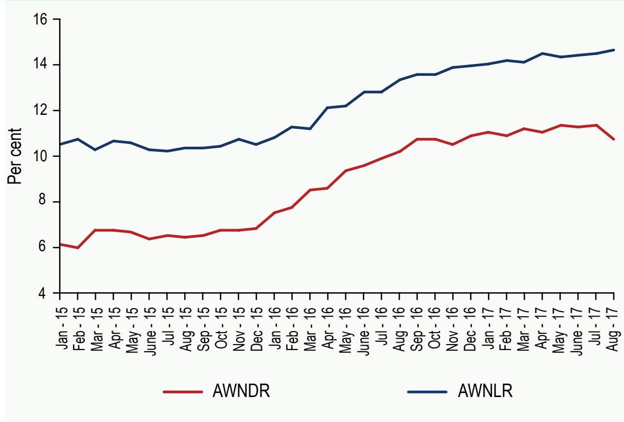
- **With the gradual transmission of the impact of tight monetary conditions, lending rates of commercial banks increased further and stabilised at high levels by end September 2017**. Reflecting the movement in short term interest rates, the weekly average weighted prime lending rate (AWPR), which is based on interest rates applicable on short term loans and advances granted by commercial banks to their prime customers during a week, increased by 74 basis points to a peak of 12.26 per cent by end July 2017 from 11.52 per cent at end 2016. Nevertheless, along with the movements in other short term interest rates amidst the gradual increase in market liquidity, weekly AWPR declined to 11.55 per cent by end September 2017. Moreover, the average weighted lending rate (AWLR), which is based on interest rates of all outstanding loans and advances extended by commercial banks to the private sector, increased by 70 basis points to 13.90 per cent by end August 2017 from 13.20 per cent that was observed at end 2016. Meanwhile, bank-wise average weighted lending rates increased to a range of 10.80-16.31 per cent by end August 2017 compared to the range of 10.12-15.66 per cent prevailed at end 2016. The average weighted new lending rate (AWNLR), which captures interest rates of all new loans and advances extended by commercial banks to the private sector during a particular month, also increased by 75 basis points to 15.12 per cent by end August 2017 from 14.37 per cent at end December 2016.

Chart 7.7
Selected Market Interest Rates



Source: Central Bank of Sri Lanka

Chart 7.8
New Deposit and New Lending Rates



Source: Central Bank of Sri Lanka

Interest Rates on Debt Instruments

- **In line with other market interest rates, interest rates applicable on corporate debt securities increased during the first eight months of 2017**. Interest rates on commercial paper, which is a short term debt instrument, increased substantially to a range of 14.25-16.50 per cent during the first eight months of 2017 compared to the range of 8.70 - 14.80 per cent observed in 2016. Meanwhile, there were seven listings of debentures by two corporates during the first eight months of 2017 with maturities of 5-8 years at various fixed and floating rates. Fixed interest rates applicable on debentures were in the range of 12.75-15.00 per cent by end August 2017 compared to a range of 9.60-13.75 per cent recorded at end 2016.

Interest Rates on Foreign Currency Deposits

- **Interest rates applicable on foreign currency deposits maintained with commercial banks increased marginally during the first nine months of 2017**. Following the increase in the Federal funds target rate in March and June 2017, interest rates on US dollar denominated savings deposits were recorded in a range of 0.02-4.23 per cent by end September 2017 compared to the range of 0.02-3.62 per cent observed at end 2016. Moreover, interest rates pertaining to US dollar denominated time deposits were in the range of 0.15-6.15 per cent by end September 2017 compared to the range of 0.15-5.00 per cent at end 2016. Meanwhile, interest rates on savings deposits denominated in pound sterling remained broadly unchanged in a range of 0.10-2.00 per cent by end September 2017 compared to the range of 0.05-2.01 per cent at end 2016. Interest rates applicable on pound sterling denominated time deposits were in the range of 0.20-4.52 per cent by end September 2017 in comparison to the range of 0.25-4.02 per cent at end 2016.

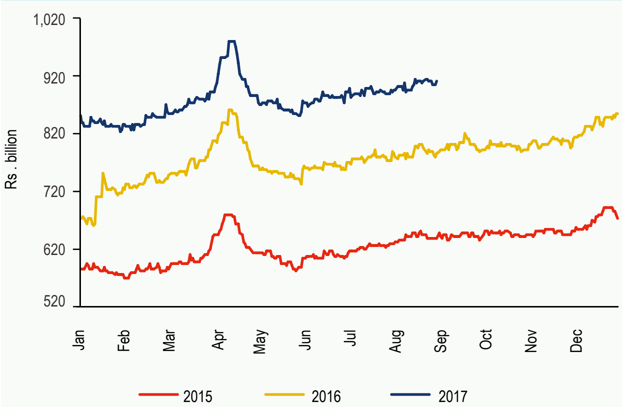
Movements in Monetary and Credit Aggregates

Reserve Money

- **Reserve money, which increased at a high rate in 2016, moderated during the first eight months of 2017 mainly on account of the high base observed in the corresponding period of 2016 due to upward adjustment in SRR in January 2016**. The year-on-year growth of reserve money decelerated to 16.0 per cent by end August 2017 compared to 27.1 per cent recorded at end 2016. In absolute terms, reserve money increased by Rs. 55.2 billion to Rs. 911.4 billion during the first eight months of 2017 compared to the increase of Rs. 112.3 billion recorded in the corresponding period of 2016, reflecting a significant moderation in the increase of commercial bank deposits with the Central Bank. From the liability side of reserve money, commercial banks' deposits with the Central Bank increased by Rs. 26.4 billion to Rs. 329.7 billion by end August 2017 compared to the increase of Rs. 82.3 billion during the corresponding period of 2016. Currency in circulation also increased by Rs. 28.9 billion to Rs. 581.7 billion by end August 2017. Although the movements in currency in circulation followed historical patterns with a sharp pickup during festive seasons, the year-on-year growth of currency in circulation was at 11.5 per cent by end August 2017 compared to 12.4 per cent during the corresponding period of 2016. With these developments, reserve money, which is considered as an indicative target under the current IMF-EFF Programme, remained below the target for the third quarter of 2017.

- **Viewed from the assets side, the increase in reserve money during the first eight months of 2017 was entirely due to the expansion in net foreign assets (NFA) of the Central Bank, while net domestic assets (NDA) of the Central Bank contracted during the period under review**. NFA of the Central Bank increased by

Chart 7.9
Daily Reserve Money (a)



Source: Central Bank of Sri Lanka

(a) Sudden changes in the movement of reserve money are due to SRR adjustments and seasonal factors.

Rs. 187.2 billion during the first eight months of 2017 compared to the decline of Rs. 77.2 billion in the corresponding period of 2016. The expansion in NFA of the Central Bank was attributable to the increase in Central Bank's foreign currency financial assets, particularly with the foreign exchange purchases of the Central Bank from the domestic foreign exchange market as well as the conversions of proceeds of the ISB and the syndicated loans obtained by the government. In contrast to the buildup of NFA, NDA of the Central Bank contracted by Rs. 131.9 billion to reach Rs. 165.6 billion during the first eight months of 2017 in comparison to the significant increase of Rs. 200.3 billion recorded during 2016. The decline in NDA was mainly due to the contraction in net credit to the government (NCG) by the Central Bank. With the Central Bank retiring its Treasury bill holdings, NCG by the Central Bank declined by Rs. 119.5 billion to Rs. 293.5 billion during the first eight months of 2017 compared to an increase of Rs. 166.6 billion during the corresponding period of 2016. Significantly contributing to the contraction in NCG, Central Bank Treasury bill holdings (net of repurchase transactions) declined by Rs. 239.8 billion to Rs. 90.2 billion by end August 2017, compared to the historically highest level of Rs. 330.0 billion recorded at end 2016. In addition to allowing the Treasury bill holdings to mature, the Central Bank conducted auctions to sell its Treasury bills on an outright basis to absorb excess liquidity in the market permanently since mid July 2017. Nevertheless, provisional advances to the government by the Central Bank increased by Rs. 120.3 billion to Rs. 203.7 billion by end August 2017.

Narrow Money (M_1)

- **The year-on-year growth of narrow money (M_1) continued to moderate during the first eight months of 2017 reflecting the increased opportunity cost of holding money in an environment of high market interest rates**. M_1, which consists of the most liquid financial assets such as currency and demand deposits, recorded a moderate growth of 6.3 per cent, year-on-year, by end August 2017 compared to 8.6 per cent by end 2016. With regard to the components of M_1, currency held by the public grew by 9.7 per cent, year-on-year, during the first eight months of 2017 compared to a growth of 10.7 per cent in 2016, and accounted for around 87 per cent of the expansion in M_1. Demand deposits held by the public with commercial banks grew only by 1.9 per cent, year-on-year, during the first eight months of 2017 compared to 6.2 per cent recorded in 2016. In absolute terms, demand deposits held by the public with commercial banks increased by Rs. 6.0 billion during the 12 months ending August 2017 compared to the increase of Rs. 23.5 billion recorded in the preceding 12 months.

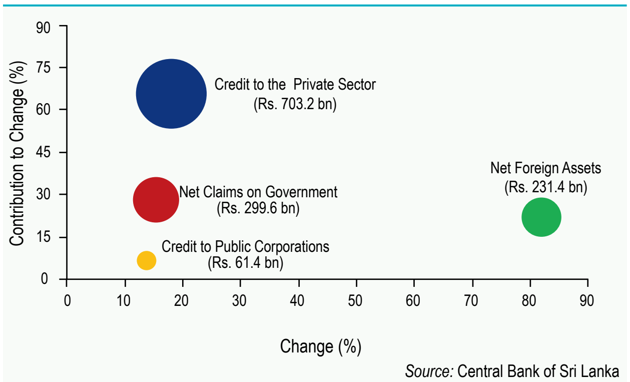
Broad Money (M_{2b}) and Domestic Credit

- **Broad money supply (M_{2b}) continued to expand at a high rate during the first eight months of 2017**. The year-on-year growth of M_{2b} was 21.3 per cent by end August 2017 compared to a growth of 18.4 per cent by end 2016, while the average growth stood at 20.1 per cent during the first eight months of 2017 compared to 18.1 per cent in 2016. The expansion in M_{2b} is attributable to both NDA and NFA of the banking system. During the period under review, NDA contributed 78 per cent to the year-on-year expansion in broad money aggregates, while NFA accounted for the remainder.

- **On the liability side, the increase in time and saving deposits held by the public with commercial banks largely contributed to the expansion in M_{2b}.** High market interest rates driven by the tight monetary policy stance continued to attract considerable amounts of interest bearing deposits to commercial banks. As a result, time and saving deposits of the commercial banking sector increased by Rs. 1,017.1 billion during the 12 months ending August 2017 compared to an increase of Rs. 671.9 billion recorded during the previous 12 months. Contributing around 96 per cent of the expansion in M_{2b}, time and saving deposits grew by 23.8 per cent, year-on-year, by end August 2017 compared to 20.2 per cent at end 2016. Meanwhile, demand deposits held by the public with commercial banks recorded only a moderate growth during the 12 months ending August 2017.

- **On the assets side, NFA of the banking sector increased during the first eight months of 2017, led largely by the NFA of the Central Bank**. In absolute terms, NFA of the banking sector increased significantly by Rs. 181.1 billion during the first eight months of 2017 (Rs. 231.4 billion in the 12 months ending August 2017) compared to the increase of Rs. 66.9 billion in 2016 entirely on account of the increase in NFA of the Central Bank by Rs. 187.2 billion resulting from the increase in international reserves of the Central Bank. Although NFA of commercial banks have gradually improved since June 2017 underpinned by the contraction in foreign liabilities of commercial banks, on a cumulative basis, NFA of commercial banks declined by Rs. 6.0 billion during the first eight months of 2017 compared to an increase of Rs. 93.8 billion in the corresponding period of 2016. This is attributable to the net impact of the decrease in NFA of OBUs by Rs. 18.7 billion and the increase in NFA of DBUs by Rs. 12.7 billion during the first eight months of 2017. The contraction in NFA of OBUs was due to a combination of several factors such as increased deposits from non-residents and the decline in credit to non-residents, amidst the contraction in borrowings from banks abroad. NFA of DBUs of commercial banks increased during the first eight months of 2017 largely on account of the decline in borrowings from banks abroad, although foreign currency placements with banks abroad also recorded a contraction during the period under review.

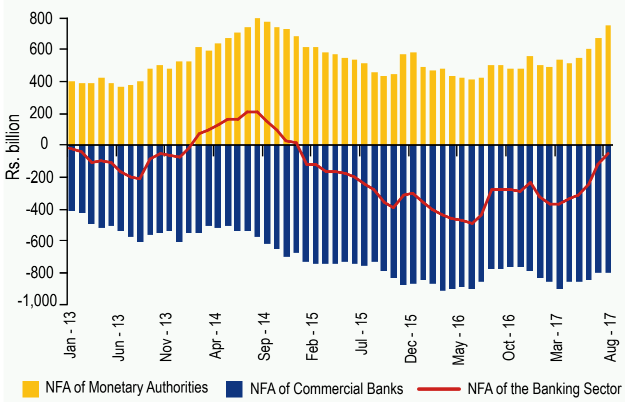
Chart 7.10
Key Contributory Factors to Year-on-Year Growth of Broad Money (M_{2b}) (a)



Source: Central Bank of Sri Lanka

(a) The size of the bubble represents the change in sources of broad money (M_{2b}) in absolute terms (Rs. bn) from August 2016 to August 2017.

Chart 7.11
Net Foreign Assets (NFA) of the Banking Sector



Source: Central Bank of Sri Lanka

- **NDA of the banking sector continued to expand during the first eight months of 2017 due to increased credit disbursements to both private and public sectors**. In absolute terms, NDA of the banking system increased by Rs. 463.8 billion during the first eight months of 2017 (Rs. 830.6 billion in the 12 months ending August 2017) contributing towards 78 per cent of the monetary expansion compared to an increase of Rs. 406.0 billion observed during the corresponding period of 2016. The expansion in NDA of the banking sector thus far in 2017 was driven by credit flows to the private sector, the government as well as to public corporations, despite the deceleration in private sector credit growth observed since July 2016 and the moderate increase in credit to public corporations during the first eight months of 2017.

- **NCG by the banking sector continued to increase during the first eight months of 2017 contributing around 57 per cent of the expansion in NDA**. NCG from the banking system increased by Rs. 265.4 billion during the first eight months of 2017 compared to the increase of Rs. 178.4 billion in the corresponding period of 2016. The increase in NCG is entirely attributable to the expansion in NCG from commercial banks, while NCG from the Central Bank contracted considerably during the period under review. Accordingly, NCG from commercial banks increased significantly by Rs. 384.9 billion in the first eight months of 2017 in comparison to the increase of Rs. 11.8 billion in the corresponding period of 2016. The increase in NCG of commercial banks was driven by the credit disbursed by both DBUs and OBUs of commercial banks. NCG by DBUs increased by Rs. 323.6 billion in the first eight months of 2017 following the increase of Rs. 96.6 billion in 2016 mainly driven by investments in Treasury bills and SLDBs amounting to Rs. 255.4 billion and Rs. 39.5 billion, respectively. Meanwhile, government overdraft balances with commercial banks also increased by Rs. 50.6 billion during the period under review. Nevertheless, investments in Treasury bonds by commercial banks contracted by Rs. 14.7 billion during the first eight months of 2017. Moreover, NCG by OBUs increased by Rs. 61.3 billion during the first eight months of 2017, following a contraction of Rs. 67.1 billion by end 2016. This was mainly due to an increase in investments in SLDBs by Rs. 22.1 billion and the increase in foreign currency loans to the government amounting to Rs. 39.2 billion. Meanwhile, reversing the trend observed during 2016, NCG of the Central Bank declined significantly by Rs. 119.5 billion during the first eight months of 2017. This decline was entirely due to the notable reduction in Treasury bill holdings (net of repurchase transactions) of the Central Bank by Rs. 239.8 billion during the first eight months of 2017 to reach Rs. 90.2 billion. The Central Bank allowed a considerable amount of Treasury bills to mature during the period under review, while outright sales of Treasury bills by the Central Bank during the months of July and August 2017 to absorb excess liquidity in the market on permanent basis also contributed to the recorded contraction in Treasury bill holdings of the Central Bank. Meanwhile, provisional advances to the government by the Central

Table 7.2
Domestic Credit Expansion and Contributory Factors

Period	Absolute Change (Rs. billion)				Share of Domestic Credit (%)		
	Domestic Credit (a)	Credit to Private Sector	Net Credit to the Government	Credit to Public Corporations	Credit to Private Sector	Net Credit to the Government	Credit to Public Corporations
2013	504.7	175.9	256.1	72.6	34.9	50.7	14.4
2014	439.4	223.9	134.6	80.9	51.0	30.6	18.4
2015	1,091.9	691.4	323.6	76.9	63.3	29.6	7.0
2016	939.6	754.9	212.6	-27.9	80.3	22.6	-3.0
Jan - Aug 2016	553.3	456.3	178.4	-81.5	82.5	32.3	-14.7
Jan - Aug 2017	**677.8**	**404.6**	**265.4**	**7.8**	**59.7**	**39.2**	**1.2**

(a) Domestic Credit includes Credit to the Private Sector, Net Credit to the Government and Credit to Public Corporations.

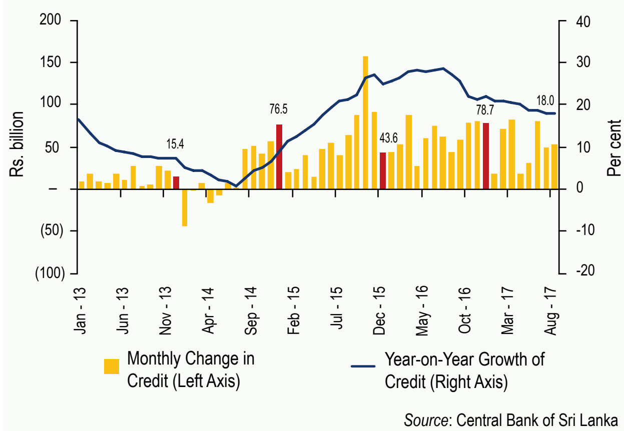
Source: Central Bank of Sri Lanka

Bank, which recorded a sharp increase of around Rs. 120 billion to Rs. 203.7 billion in January 2017 with the full utilisation of the entitlement for the year, remained almost unchanged by end August 2017.

- **The increasing trend in credit to public corporations since September 2016 continued during the first five months of 2017, but moderated thereafter**. The total cumulative increase in credit obtained by public corporations in 2017, which amounted to Rs. 66.6 billion by end May, subsequently reduced to Rs. 7.8 billion by end August 2017, compared to a contraction of Rs. 81.5 billion recorded in the corresponding period of 2016. The increase in credit to public corporations during the first eight months of 2017 was largely driven by borrowings by National Water Supply and Drainage Board (NWS&DB) amounting to Rs. 16.2 billion, Road Development Authority (RDA) amounting to Rs. 7.8 billion and SriLankan Airlines amounting to Rs. 7.6 billion. Although, Ceylon Petroleum Corporation (CPC) repaid around Rs. 52.8 billion of its loan liabilities during the period from May to August 2017, containing the overall expansion in credit to public corporations, net repayment by CPC was limited to Rs. 10.8 billion during the first eight months of 2017 as a result of their borrowings during the first four months of 2017. Further during the first eight months of 2017, Urban Development Authority, Ceylon Fertilizer Corporation, Ceylon Electricity Board (CEB), Paddy Marketing Board, Colombo Commercial Fertilizer Corporation and Sri Lanka Ports Authority also partially settled their loan liabilities to commercial banks by Rs. 6.5 billion, Rs. 2.7 billion, Rs. 2.6 billion, Rs. 1.8 billion, Rs. 1.3 billion and Rs. 1.1 billion, respectively.

- **In an environment of high nominal and real interest rates, the growth of credit to the private sector by commercial banks showed signs of deceleration during the first eight months of 2017**. In addition to the upward adjustment in policy interest rates in view of high

Chart 7.12
Credit Granted by Commercial Banks to the Private Sector



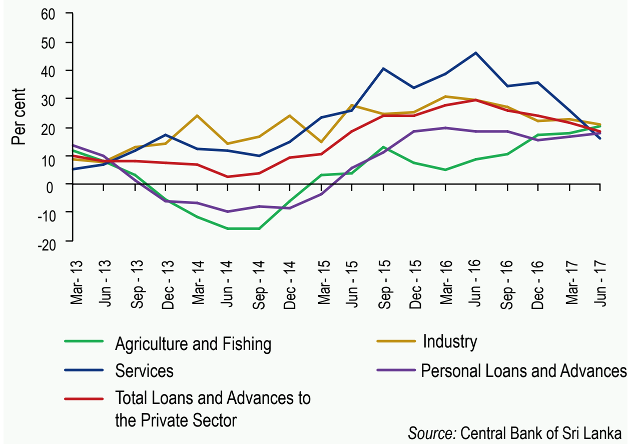
Source: Central Bank of Sri Lanka

credit expansion, macroprudential measures and tariff adjustments to discourage selected imports also contributed to the deceleration of private sector credit growth. Accordingly, the year-on-year growth of credit to the private sector was at 18.0 per cent by end August 2017 compared to 21.9 per cent at end 2016 and the peak level of 28.5 per cent recorded in July 2016. In absolute terms also, the growth of credit to the private sector in the first eight months of 2017 remained below the expansion observed in the corresponding period of 2016. Accordingly, credit to the private sector increased by Rs. 404.6 billion during the first eight months of 2017 compared to the increase of Rs. 456.3 billion in the corresponding period of 2016. Meanwhile, the removal of interest rate caps on credit cards, other loans and advances and penal interest rates charged on overdue loans and advances by licensed banks with effect from 01 July 2017 could also dampen the demand for credit by the private sector to some extent in the period ahead.

- **Credit granted to all major sectors continued to expand during the first half of 2017, although at a slower rate than in 2016**. As per the Quarterly Survey of Commercial Banks' Loans and Advances to the private sector, credit to the Industry sector and the Agriculture sector grew by 21.1 per cent and 20.5 per cent, on a year-on-year basis, respectively, by end June 2017. In the Agriculture sector, credit to all sub sectors recorded positive growth rates, and credit to Coconut, Paddy, Livestock and Dairy Farming and Fisheries grew by more than 35 per cent, year-on-year, by end June 2017. This increase in growth of credit to the Agriculture sector could be, in part, a reflection of increased borrowings to support the recovery from weather related disruptions in certain regions. Meanwhile, credit flows towards all sub sectors of the Industry sector recorded positive growth rates, with the Construction sector, which accounts for around 48 per cent of the total credit flows to the Industry sector and around 20 per cent of total private sector credit, recording a growth of 21.8 per cent, year-on-year, by end June 2017. Growth in credit to the Services sector moderated to 15.8 per cent by end June 2017 compared to the growth of 46.1 per cent recorded during the corresponding period of 2016 largely on account of the moderation in credit flows to the Financial and Business Services sub-sector. Further,

Chart 7.13

Year-on-Year Growth of Credit Granted by Commercial Banks to Key Sectors



Source: Central Bank of Sri Lanka

credit flows to sub sectors of Tourism, Transport, Printing and Publishing, and Education recorded relatively high growth rates, while credit to the sub-sector of Shipping, Aviation and Freight Forwarding contracted by 12.9 per cent by end June 2017. Credit under the Personal Loans and

Table 7.3

Classification of Outstanding Credit to the Private Sector Granted by Commercial Banks (a)(b)

Rs. billion

Sector	End June 2016 (c)	End June 2017 (d)	Year-on-Year Change	
			Amount	%
Agriculture and Fishing	**317.0**	**382.0**	**65.0**	**20.5**
of which, Tea	78.1	84.6	6.6	8.4
Rubber	20.4	25.3	4.9	23.8
Coconut	12.5	19.6	7.0	56.0
Paddy	23.5	32.3	8.9	37.8
Vegetables, Fruit and Minor Food Crops	22.0	27.2	5.2	23.6
Fisheries	12.3	16.8	4.5	36.8
Industry	**1,539.6**	**1,864.0**	**324.4**	**21.1**
of which, Construction	741.0	902.8	161.8	21.8
Food and Beverages	86.5	103.6	17.2	19.8
Textiles and Apparel	144.7	156.8	12.0	8.3
Fabricated Metal Products, Machinery and Transport Equipment	126.5	158.5	32.0	25.3
Services	**1,149.7**	**1,331.0**	**181.3**	**15.8**
of which, Wholesale and Retail Trade	353.6	400.0	46.3	13.1
Tourism	118.8	160.4	41.7	35.1
Financial and Business Services	282.2	306.6	24.4	8.7
Shipping, Aviation and Freight Forwarding	26.1	22.7	-3.4	-12.9
Personal Loans and Advances (e)	**824.2**	**972.1**	**147.9**	**17.9**
of which, Consumer Durables	172.0	207.0	35.1	20.4
Pawning	122.3	137.5	15.2	12.4
Total	**3,830.5**	**4,549.1**	**718.6**	**18.8**

(a) Based on the Quarterly Survey of Commercial Banks' Loans and Advances to the Private Sector.

(b) Includes loans, overdrafts and bills discounted and purchased and excludes cash items in the process of collection

(c) Revised

(d) Provisional

(e) Excludes personal housing loans, which have been included under 'Construction' classified under 'Industry' and includes credit card advances

Source: Central Bank of Sri Lanka

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Advances category grew by 17.9 per cent, year-on-year, during the first half of 2017, a marginal moderation compared to the growth of 18.7 per cent recorded in the corresponding period of 2016. Within this sub-sector, credit disbursed under credit cards grew by 22.6 per cent during the first half of 2017. Pawning Advances, which continued to decline since September 2013, reversed this trend during the first half of 2017, recording a year-on-year growth of 12.4 per cent by end June 2017. This was mainly attributable to the rise in international gold prices as well as gold imports. Nevertheless, growth in credit disbursed to purchase consumer durables decelerated to 20.4 per cent by end June 2017 compared to the significant growth of 58.9 per cent recorded in the corresponding period of the previous year. With regard to the maturity-wise analysis of credit, the year-on-year growth of short term loans accelerated to 18.4 per cent by end June 2017 compared to 15.7 per cent recorded in the corresponding period of 2016. Meanwhile, growth in medium and long term loans moderated significantly to 14.2 per cent and 23.3 per cent, respectively, by end June 2017, compared to 25.6 per cent and 55.8 per cent, respectively, at end June 2016.

Broad Money (M_4)

- **Growth of broad money supply (M_4)[1], as measured by the financial survey, moved in line with the growth of M_{2b}.** By end August 2017, M_4 grew at a higher rate of 20.7 per cent compared to a growth of 15.9 per cent recorded at end 2016. Viewed from the liability side of M_4, total time and savings deposits held by the public with licensed commercial banks (LCBs), licensed specialised banks (LSBs) and licensed finance companies (LFCs) grew by 22.7 per cent,

1 Financial Survey provides a broader measure of liquidity, covering LSBs and LFCs, in addition to LCBs and the Central Bank.

Table 7.4

Assets Side of Broad Money (M_4)
(Computed as per the Financial Survey)

Rs. billion

Sector	End Aug-16	End 2016	End Aug-17 (a)	Year-on-Year Change			
				End 2016		Aug-17	
				Amount	%	Amount	%
Financial Survey (M_4)	**6,178.8**	**6,630.3**	**7,457.0**	**910.0**	**15.9**	**1,278.2**	**20.7**
Underlying Factors							
Net Foreign Assets	**-429.1**	**-383.2**	**-205.2**	**61.0**	**13.7**	**223.9**	**52.2**
Monetary Authorities	499.0	558.6	745.8	-17.6	-3.1	246.8	49.4
LCBs	-780.5	-789.8	-795.9	84.5	9.7	-15.3	-2.0
LSBs & LFCs	-147.6	-152.0	-155.1	-6.0	-4.1	-7.6	-5.1
Net Domestic Assets	**6,607.9**	**7,013.5**	**7,662.3**	**849.1**	**13.8**	**1,054.4**	**16.0**
Domestic Credit	**8,293.2**	**8,763.3**	**9,595.6**	**1,159.6**	**15.3**	**1,302.4**	**15.7**
Net Credit to the Government	**2,529.4**	**2,555.9**	**2,843.2**	**211.6**	**9.0**	**313.7**	**12.4**
Monetary Authorities	396.5	413.0	293.5	183.1	79.6	-103.0	-26.0
LCBs	1,541.4	1,559.1	1,944.0	29.6	1.9	402.6	26.1
LSBs	527.0	515.7	541.4	-13.6	-2.6	14.5	2.7
LFCs	64.5	68.1	64.2	12.5	22.5	-0.3	-0.5
Credit to Public Corporations (LCBs)	**441.5**	**495.1**	**502.9**	**-27.9**	**-5.3**	**61.4**	**13.9**
Credit to the Private Sector	**5,322.3**	**5,712.3**	**6,249.5**	**975.9**	**20.6**	**927.2**	**17.4**
LCBs	3,905.9	4,204.4	4,609.1	754.9	21.9	703.2	18.0
LSBs	528.2	562.2	631.9	80.5	16.7	103.7	19.6
LFCs	888.2	945.7	1,008.6	140.5	17.4	120.3	13.5
Other Items (net) (b)	**-1,685.3**	**-1,749.8**	**-1,933.3**	**-310.6**	**-21.6**	**-248.0**	**-14.7**

(a) Provisional
(b) Computed as the difference between other assets and other liabilities.

Source: Central Bank of Sri Lanka

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year-on-year, by end August 2017, compared to 17.1 per cent growth recorded at end 2016. Time and savings deposits held at LSBs and LFCs grew by 15.5 per cent and 25.6 per cent, respectively, by end August 2017, supported by high and competitive interest rates offered for deposits during the period under review. From the assets side, largely contributing to the expansion in M_4, NDA of licensed banks and LFCs increased by Rs. 648.8 billion, while NFA also increased by Rs. 178.0 billion during the period under review.

- **The growth in credit to the private sector in the financial survey also displayed a moderation during the first eight months of 2017**. According to M_4, growth in credit to the private sector moderated to 17.4 per cent, year-on-year, by end August 2017 compared to 20.6 per cent at the end of 2016. Following the same trend, credit growth of LFCs moderated to 13.5 per cent, year-on-year, by end August 2017 compared to 17.4 per cent at end 2016. In contrast, credit growth of LSBs increased to 19.6 per cent, year-on-year, by end August 2017 compared to 16.7 per cent recorded at end 2016. In absolute terms, the growth of credit amounted to Rs. 537.2 billion during the first eight months of 2017 compared to the increase of Rs. 585.9 billion in the corresponding period of 2016. Further, NCG by all institutions covered in the financial survey recorded an increase during the period under review. Accordingly, overall NCG increased by Rs. 287.3 billion during the first eight months of 2017 compared to an increase of Rs. 185.1 billion during the same period of the previous year.

Expected Developments

- **The monetary policy framework of the Central Bank is being further strengthened with the aim of adopting a FIT framework over the medium term**. The key aspects of this transition include introducing necessary legal reforms, building institutional and technical capacity, strengthening central bank credibility and autonomy, enhancing government-central bank coordination, continuing the market based flexible exchange rate regime, improving monetary policy operations and enhancing public and stakeholder awareness. In the near future, the Central Bank intends to announce a Road Map, with the support of the government, to facilitate a smooth transition towards completing the remaining building blocks necessary for adopting this new monetary policy framework. In the recently published policy document "Vision 2025: A Country Enriched", the government has also indicated its willingness to further strengthen the legal framework of the Central Bank to conduct its monetary policy more efficiently under the FIT framework and to allow greater flexibility in exchange rate determination.

- **The unhindered progression of the ongoing fiscal consolidation process is essential for the smooth transition and successful implementation of FIT**. There is a strong need for enhanced monetary-fiscal coordination at this juncture with the government's commitment to the ongoing revenue-based fiscal consolidation process to ensure the success of the FIT framework in maintaining low and stable inflation over the medium term. The improved fiscal space will provide the Central Bank with enhanced flexibility to conduct its monetary policy more effectively and independently, that will pave way for a more growth-conducive environment supported by low levels of market interest rates on a more predictable and consistent basis.

- **With prudent monetary policy measures and short term cost adjustments by the government, the disturbances to price levels observed at present are expected to dissipate in the near term**. The increase in inflation observed during the most part of 2017 was mainly associated with tax revisions and supply disruptions caused by inclement weather conditions along with upward movements in international commodity prices. However, underlying inflation as indicated by core inflation has remained at tolerable levels in view of proactive monetary policy measures adopted by the Central Bank. While the Central Bank is committed to contain demand driven inflation through monetary policy measures and anchor inflation expectations towards targeted level of inflation, short and medium term actions are necessary to curb food inflation, which remains a serious concern. As a large proportion of the consumption basket comprises food items and imported components, supply disruptions in the domestic economy and the surge in international commodity prices, including oil, threaten price stability. Strengthening domestic supply networks and strengthening safety nets to dampen the impact of supply disturbances on the vulnerable segments of the population are necessary to increase the resilience of the economy to such disturbances.